

1 Financial regulation: consumer safeguard or straitjacket?

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Presenter and panel



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The debate

Introduction

This paper offers a thematic summary of discussions from our first event, which was held on 8th July 2009. Our paper author, John Howard, set out his views in a discussion paper which you can download from www.focusonfinance.org.uk

The debate will be used to inform Consumer Focus's policy development, but the summary below should not be taken as Consumer Focus policy.

The central question at the heart of the debate was how much protection consumers need when buying financial products and services. There has been an erosion of trust between financial institutions and their customers following the banking crisis and a series of misselling scandals. In determining the appropriate policy response, a key challenge is to strike the right balance between properly safeguarding consumers and avoiding a straitjacket which restricts availability of products and services or inappropriately stifles innovation that benefits customers and society.

From the outset John argues that while we can't have a perfect system of regulation that protects all consumers all of the time, we must make incremental changes and learn from past experiences to improve the system. What might those changes be?

Macro-prudential framework

“Intervention on an individual firm basis will always be difficult but action across all firms to target systemic risks stands a much better chance. What we need for the whole sector is the regulatory equivalent of the governor on a steam engine.” John Howard

Consumer protection ultimately starts with ensuring that the firms people buy products from are soundly run and well capitalised. Financial stability is key to consumer confidence in financial institutions and underpins the successful functioning of the wider goods and services economy. Achieving this is likely to require reform at both international and domestic levels.

Participants agreed that while consumer regulation in the UK had not been a direct cause of the financial crisis, or at least not as demonstrably as weak controls on lending in the USA, the crisis had shown up weaknesses in the system in areas such as depositor protection.

It was acknowledged that financial regulators have a difficult job – it would have been a courageous move indeed for the FSA to have ordered the award-winning Northern Rock to change its business model. A key question is whether systemic regulation should be tweaked or overhauled. One participant called for more radical reform of individual firms’ capital requirements and systemic risk oversight, arguing that a 2007-style crisis could happen again under the current system.

The importance of international cooperation and implementation would be crucially important to prevent regulatory arbitrage – though one comment was that the USA and EU had not fully resolved their differences on Basel II so a new settlement could be difficult to reach.

At the same time, however, firms should be allowed to fail – this is an inherent feature of capitalism. If firms were allowed to fail, we should think carefully about how certain parts of banks activities should be protected in the case of failure and on what terms government support might be offered. For example retail deposits might be treated differently to the wholesale markets activities of a bank. As a corollary of government guarantees, for

example on retail deposits, there should be a premium paid to the government by banks to ensure that the cost of providing this is built into the market price of providing banking services.

Corporate Governance

“The FSA has said that it will be more intrusive, to the point of making judgements about firms’ judgements. This has real risks for the regulator. The further it goes down this route, the more it takes over from the board and ends up running the company and being responsible when things go wrong.” John Howard

A common theme was the importance of good corporate governance in ensuring that firms are being soundly run and are not taking excessive risks which leave consumers exposed. The importance of corporate governance in preventing imprudent behaviour by banks has been underlined by the Walker Review, which will recommend new requirements on boards while the Chancellor has said that he expects boards of financial institutions to be the first line of defence in a financial crisis.

One participant argued that it was absolutely essential that the burden of responsibility must remain with boards, as firms are the originators of risk. Concern was expressed that there is a danger that a knee-jerk regulatory response could end up moving the burden of responsibility to the regulator which would have a negative impact in the long run. It was noted that the FSA’s approach is increasingly about asking boards to robustly evidence and defend their assumptions rather than to make decisions for them.

Another theme was the critical role of non-executive directors in good governance with concern raised that in many firms there was no culture of NEDs challenging executives adequately. Part of the problem was whether many NEDs were able or empowered to do the job entrusted to them.

Finally, one participant raised the palpable change in the public mood, and the need to consider the importance of ethics and morals in corporate governance of financial institutions. Changing corporate culture so

that firms regulate their own behaviour more effectively would require changes to be driven right from the top of firms.

Advice and Sales

“So much of what has gone wrong in the past has been due to misselling. From endowment mortgages to pensions and precipice bonds and payment protection insurance, consumers were persuaded to take on commitments which they didn’t understand and turned out to be disadvantageous.” John Howard

Financial products can be bought in different ways by consumers, each with different regulatory requirements attached to them and a different balance of responsibilities between firms, consumers and intermediaries (if there is one involved in the sale). Often customers think they are receiving personalised, independent financial advice but are in fact simply being led through a sales process. John Howard believed that incentive payments paid to sales staff are highly distorting and lead to customers buying a product regardless of whether it is appropriate. In his view, this is an inherent flaw in the way that the market currently operates.

John Howard would like to see IFAs become the consumer’s champion on the high street. To achieve this, independent advice would be based on fees paid by the client rather than commissions paid by the product provided, in order to remove any risk of so-called commission-bias. This would permit high street salespeople to sell only approved safe products, while independent advice would have to be taken on the wider range of products unless they were bought on a ‘execution only’ basis, i.e. on the instruction of the consumer without advice.

The FSA’s moves to remedy commission bias and improve standards of advice in the market for retail investments through the Retail Distribution Review were broadly welcomed. However, it was noted that while these proposals might work for people who could afford good advice, they didn’t do much to improve access to advice for those who could not. The introduction of an impartial Money Guidance service was welcomed as a positive step towards helping consumers

navigate financial services, but it would not be able to make specific product recommendations to consumers.

Safe products (product regulation)

“What we need are simple products, easy to understand...even if it’s not the best product you will not lose out if you buy it” John Howard

The issue of safe products was the hot topic of the seminar. John Howard strongly advocates the creation of a suite of ‘vanilla products’ that, while they might not be the best on the market, would have features that minimise the chances of misselling and thus consumer detriment. He suggested that these products might have no more than half a page of information to explain them so that customers would always understand what they are buying.

This created considerable discussion. Participants recognised this was a debate whose ‘time had come’, but there was considerable disagreement as to whether this was the right approach or not. A number of criticisms were levelled at the safe products proposition. At the core of the issue was a definitional problem: what do we mean by “safe” and what makes a financial product fit for purpose, given that not only is every customer different but their needs change over time?

Simplicity is often offered as key feature of a safe product. It was questioned as to whether it was complexity of products that lay at the heart of the misselling problem: in many cases the worst misselling had involved relatively simple products such as payment protection insurance. Often it was the interaction of individuals’ circumstances with product features that created the problems.

Another view was that we had been down this route before with Sandler products and they had not taken off in the way that the government would have liked. John Howard responded that the market should be free to set charges and that charge capping had put providers off the Sandler package. Indeed, there was a strong call for a review of lessons from previous policy interventions into product regulation such as

basic bank accounts, Child Trust Fund and stakeholder products to see what we can learn from them.

One alternative offered was for the regulator to set 'safe' parameters within which product providers were free to innovate – this would be less restrictive and would allow more competition. However, there was also apprehension about giving products a 'safe' stamp of approval if it later turned out they were not in fact safe; this would have a highly corrosive effect on consumer trust and left open the question of who would pick up the tab for possible compensation claims.

Other practical problems were foreseen: it would be difficult to implement on the ground and might be circumvented by providers through regulatory arbitrage. Even if it could be implemented, similar approaches in other markets around the world had not prevented the problems we see in the UK.

But by just looking at products are we guilty of setting our sights too low? Should we not also look at the macro-level risks that ultimately lead to consumers losing out, such as the wide swings in property prices. This would entail reviewing policy in a number of areas such as planning policy and inflation targeting to keep property prices more stable. This might potentially have a much bigger impact by undermining the damaging property-centric mindset that appears to have taken hold in the UK.

Financial capability and the role of consumers

“Financial capability has two aspects. First, it is central to protecting people: it’s just much harder to take advantage of a savvy customer. But second, it’s also about engaging them with what they need to do to stand a chance of a secure independent future, and about setting those reasonable expectations about what the system can do for them. One is about eliminating a negative, the other’s purely a positive.” Otto Thoresen

Improving financial capability, i.e ensuring consumers have the ability to manage money, keep track of their finances and plan ahead by making use of generic information, financial advice and financial education, is a key part of improving consumer outcomes.

However, despite the efforts of the FSA and other parties this is, by its nature, a long-term strategy and will take a generation to make a full impact.

As such financial capability is not a panacea and can only work in the context of a market that is appropriately regulated. Even the cleverest people, one contributor commented, are bamboozled by financial products.

A key challenge ahead is to understand what drives this complexity and aim to simplify things where possible. Evidence from the UK and abroad suggests that several factors have helped to create complexity including: the tax code and its interaction with products; the regulatory rulebook which requires firms to provide extensive paperwork to clients which they simply don't read or don't understand and the 'compliance industry' which has driven an over cautious and legalistic approach leading to impenetrable terms and conditions that covers firms but are not in the interests of customers.

Underlying discussions about financial capability is the tricky topic of what level of responsibility consumers themselves should take. “What happened to caveat emptor in financial services?” was a question asked by one of the contributors.

This has proved to be a controversial area: the FSA's recent consultation exercise on consumer responsibility provoked sharp criticism from its consumer panel but welcoming noises from the industry.

Arguably, removing risk from consumers would not encourage people to engage with financial services and demand more from providers. On the other hand, given low levels of financial capability, a high degree of product complexity and the potentially severe consequences if things go wrong, are financial services a market where a different set of assumptions should apply?

You can listen to an exclusive podcast from the first debate at:

www.focusonfinance.org.uk/debate1.html